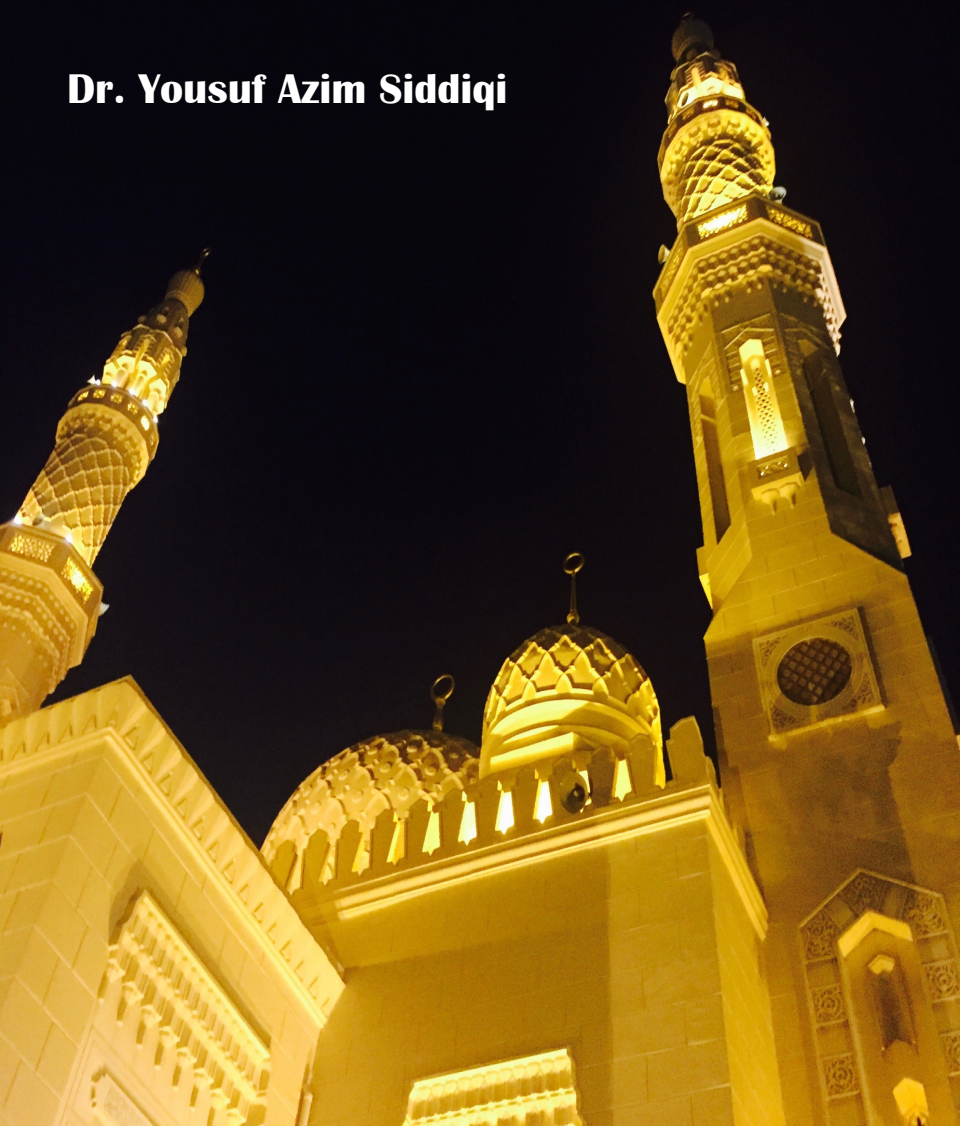


Introducing

Islamic Banking

Dr. Yousuf Azim Siddiqi



Introducing Islamic Banking

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Review of the First Edition

“Excellent Work”

Nizar Alshubaily

“Beautifully simple and easy to understand by people new to Islamic banking”

Nida Davis (USA)

“The book is interesting first of all by its authorship. It was written by the practitioner, who built a career in commercial banking in UAE and was actively involved in implementing and devising many innovative banking instruments and projects in the Middle East. That is why the value of the book is not only purely academic but is backed up by the first-hand practical experience. However, the main achievement of the author was to systematize existing knowledge on the problem in order to provide it in encyclopedia-like form.

The introduction of the book explains the background of the problem and author’s path to obtain expertise and knowledge to write the book. The author intrigues the reader by mentioning current scale, prospects of development of Islamic banking and its potential entry into the new markets. A well-written introduction motivates to proceed reading to understand whether your business or research is or will be impacted by the subject of the book in the nearest time.

The book provides a substantial overview of the Islamic banking, tackling main terms, forms of contracts, myths, problems. Possible contacts under Islamic banking are described in details depending on the market situations that can occur with the participation of bank and client.

The mentioned issues are discussed in more detail in several laconic parts presenting information on each problem under analysis in separate subsections. The structure may be helpful for anyone wishing to obtain basic knowledge in the field but will probably distract the readers who have some knowledge on the subject. Therefore, this could be both the strength and the weakness of the book depending on the reader.

Despite numerable merits, there are few aspects that the author may improve upon in the next edition. One such instance concerns the actual introduction of Islamic banking in new markets. With elaborate information on Islamic banking, the book rather promotes Islamic banking for new markets than suggests a road-map of its introduction in new markets. If further dwelt upon, this could be of a great practical value.

In the Conclusions section, the author makes an interesting suggestion on how the Islamic banking should be called in order to be implemented in new markets. This may be regarded as one of the original statements delivered by the author in the manuscript and in the next edition of the book the whole chapter could be devoted to this problem.

The book will be interesting for scholars who investigate the issue of Islamic finance as well as for business owners and practitioners who deal or intend to deal with the financial institutions under Islamic regulations in their professional activity.”

Yaroslav Mozghovi

Journal of Governance & Regulation, 6 (3), 67.

Dr. Yousuf Azim Siddiqi worked for more than a decade as a Shari'a personnel in various Islamic banks. He was associated with ADIB, Arcapita, Dubai Bank and, finally, Emirates Islamic.

He actively participated in developing some of the most innovative Shari'a compliant products, like Nasdaq Murabaha Certificates, Repo of Murabaha Debt, Hybrid Ijarah, etc. He was part of core team of EIB's USD 2 Billion Sukuk Programme (2016). He has an interest in writing in English, Arabic and Urdu on Islamic jurisprudence and history.

B.Com. from Ness Wadia College of Commerce (Pune), MBA (Finance) from the University of Wales (UK) and Ph.D. (Islamic Economics) from the Open Islamic University (Egypt).

Dr. Siddiqi provides advisory services to Islamic banks and financial institutions in developing Shari'a compliant products. Also, he is active in training and writing.

Lives in Kuala Lumpur with his wife and daughter (Khadija).

To Mufti Muhammad Taqi Usmani
For his immense contribution in
Shari'a guidance of Islamic banking industry

To my father –
Mr. (Late) Aleem Ahmad Siddiqi
Whose dream was to see
Islamic Banking achieve a global presence

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FOREWORD

Datuk Dr Mohd Daud Bakar¹

Lack of understanding and ignorance are always detrimental in life. We always appreciate those who spent their time to remove this undesired malaise. Islamic finance is a journey. Those who are passionate about Islamic finance will find the way to find the true values of Islamic finance.

I have read the manuscript of this book with great pleasure. The book will definitely make the understanding of Islamic banking in practice easy, internalised, as well as rejuvenating. As in many other books in other fields of life, it will need the author to be hands-on to write a better story. The author of the book is a practitioner himself.

In this book, the author has demonstrated his deep knowledge of the practical aspects of the Islamic finance industry, as well as the milestones of the industry going through a very long journey. I would like to believe that this book will be a good contribution to every stakeholder. I have enjoyed reading it and I would like you to have the same experience.

1. Datuk Dr. Mohd Daud Bakar is one of the renowned Shari'a scholars of Malaysia. He sits on the Shari'a Supervisory Board of many Islamic banks, funds and insurance companies. He is also Chairman of the Shariah Advisory Council at the Central Bank of Malaysia. His recent book (*Shari'a Minds*) is making waves across the world.

FOREWORD

Dr Aznan Hasan¹

Since 1975, Islamic banking industry has evolved through many phases of development where constant product innovation helped to address banking needs of Muslims. It is worth mentioning that global Islamic banking is a multi-billion-dollar industry. Banks in the Middle East and Malaysia have lion's share of this industry.

Despite Islamic banking's economic utility and substantial presence in many countries of the world, Islamic banking remained a distant dream in some countries where, surprisingly, Muslims constitute a significant portion of the local population. Factors which contributed to delay in introducing Islamic banking in green-fields are, somehow, regulatory and, mostly, related to ignorance leading to growing myths about Islamic banking.

The author of this book felt the need to gather very-basic information related to functions of Islamic banks, myths surrounding the same, thumb-rules of developing Shari'a products and modus operandi of retail and corporate products. I hope this book will help regulators and new investors to understand basics of Islamic banking.

1. Dr. Aznan Hasan is a faculty member of IIUM (Malaysia), Member of AAOFI's Shari'a Board and President of Association of Shari'a Advisors in Islamic Finance (ASAS).

INTRODUCTION

Islamic banking is one of the fastest growing financial industries in the world. The need of the Islamic banking system was felt more than a century ago when Islamic jurists initiated the assessment of traditional banking products, which were prevalent in those times.

The recent times have ensured that practicing Muslims are able to meet their banking needs by utilizing various forms of trade contracts, like a sale, partnership, lease, etc. In fact, Islamic banking was competently able to cater to the diverse needs of all the segments, including retail, corporate, investments, money-market and even state-owned corporations.

Despite being a trendsetter in different parts of the world (especially in the Middle East and Malaysia), for a long time, Islamic banking remained a theoretical concept or, at least, an ambitious dream in the majority of the world. This delay has adversely impacted customers from all the segments would it be retail or corporate. One of the main reasons for this delay was the ambiguity that surrounded the Islamic banking products. Regulators, investors, as well as, the consumers were unacquainted with the actual offerings of Islamic banking. This state of ambiguity led to the

mushrooming of myths and misconceptions, which are addressed on rare occasions.

Over the course of past several years, the Author has been fortunate enough to attend selective and some of the most significant conferences on Islamic banking. Also, he has been an active contributing participant in discussions on introducing innovative Shari'a compliant products. This book attempts to clarify some of the basic concepts of Islamic banking. During the course of the description, as you will develop an understanding of the Islamic banking's history, you will also be able to comprehend the myths associated with it. The book also attempts to highlight important hurdles and challenges faced by the Islamic bankers in Emerging Markets. Most importantly, the book features some of the most common Shari'a compliant structures as offered by many Islamic banks. Towards the end, the book suggests a practical and simple road map to launch Islamic banking products in Emerging Markets.

Happy Learning!

Dr. Yousuf Siddiqi

Dubai (UAE)

15th May 2018

Acknowledgment

I would like to acknowledge the professional support extended during my Islamic banking career by *Dr. Osaid Kailni* (currently Global Head of Shari'a at ADIB), *Sh. Mohamed Isa Al-Jamea* (Ex-Director of Shari'a at Arcapita Investments) and, most importantly, my mentor in Islamic finance - *Dr. Abdulsalam Kilani* (currently the Head of Shari'a at Emirates Islamic Bank). I cannot imagine writing this book without their sincere support over a decade long period. Dr. Mohammad Omar Farooq (University of Bahrain), Dr. Mr. Sami Al Nabtiti (from the Shari'a Audit team of Emirates Islamic), and Mr. Nizar Al Shubaily (a renowned Islamic banking expert) were kind and thoughtful to review the first edition of the book word-by-word and provided me with their valuable comments and suggestions.

I am, also, thankful to *Sh. Istefaul Hasan* and *Sh. Masood Azizi* for publishing my book from *Dar a-Safwah* (Lucknow). And to *Pia Olsson* from True Editors (UK) for proofreading the first edition of the book.

Finally, I owe personal gratitude to my mother *Mrs. Naheed Siddiqi*, my brothers – *Eng. Ahmad Viqar* and *Eng. Mohammad Abdullah* and to my wife *Huma Siddiqui*.

PART 1:

Banking & Muslims' Beliefs

The Role of Banks:

An economic system in the world constitutes of, at a minimum, hundreds of organizations and thousands of individuals. All these components endeavour to search for what's good for them on the micro-level. However, only when this search exercise is done strategically and wisely, will it result in macroeconomic benefits.

Individuals and organizations are free to connect to each other for achieving best of their economic benefit. This might be true for a simple and basic economy. However, in an overall complex system, wherein information is not properly channelized, the financial intermediaries' play a vital role in connecting the missing ends. Financial intermediaries in any economic system are, for example, banks, brokerage houses, non-banking financing houses. Certainly, banks are the most important intermediary in this process of wealth circulation, which leads to macroeconomic development.

The History of Modern Banking:

Modern day banking traces its origin back to the fourteenth century. As per Tannan:

“The origin of modern banking may be traced to the money dealers in Florence who received

money on deposit, and were lenders of money in the 14th century.”¹

The Business of Banking:

As per Banking Regulation Act 1949 of **India**, a banking company is defined as per Section 5/(c) as:

“Any company which transacts the business of banking...”

Further, the explanation states:

“Any company which is engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader shall not be deemed to transact the business of banking within the meaning of this clause”.

As per The Banking Act of the **Republic of China** (amended 2015), a bank is defined in Article (2) as:

“An organization formed and registered in accordance with the provisions of this Act for purposes of transacting a banking business.”

Further Article (3) gives details about Banking Business:

“Scope of Business of Banks: Businesses which may be conducted by a Bank are as follows: 1.To accept Checking Deposits; 2.To accept various kinds of other Deposits; 3.To manage Trust Funds under mandate; 4.To issue Bank Debentures; To

1. See Pg. 3 of Banking Law and Practice in India by *M L Tannan*, published by Lexis Nexis (India).

extend loans; To discount bills and notes; 7.To invest in securities; To invest in productive enterprises; To invest in residential construction and construction for business purposes; To handle domestic and foreign remittances; 11.To accept commercial drafts; 12. To issue Letters of Credit; 13. To guarantee domestic and foreign transactions; 14.To act as collecting and paying agent; 15. To underwrite and trade in securities for its own account or for customers; 16.To manage issuance of bonds and debentures and to provide advisory services with respect thereto; 17. To act as attestor for the issuance of stocks, bonds and debentures; 18.To manage various kinds of property under mandate; 19. To conduct businesses related to investment and trusts regarding securities; 20. To buy and sell gold bars/coins and/or silver bars/ coins and foreign currencies; 21. To conduct warehousing, custody and agency businesses in relation to the businesses itemized above; and 22. To conduct other relevant businesses which may be authorized by the Central Competent Authority.”

The Classification of Banking Products:

It is evident from the definition of banking business (as given in the above banking laws) that activities of any bank can be classified in any of the following three categories:

- a. ***Loans against Interest:*** banks extend or receive loans on interest. This activity constitutes the core activity of any common bank in the world.

- b. **Services:** banks provide services against a pre-agreed fee. Some of the common services include safety lockers, currency exchange, financial advisory, etc.
- c. **Interest-free Loans:** banks give or take loans on an interest-free basis, and this covers current accounts as well short-term financial assistance extended by banks.

The offense of RIBA:

As per Islamic principles, money cannot generate money. If a person wants to compound his money then it is recommended that he enters in a trading or partnership arrangement. Claiming extra money over money is a form of **Riba**, which is the Islamic term for usury, as defined in the Islamic teachings. The Quran clearly states:

“Those who take Riba (usury or interest) will not stand but as stands the one whom the demon has driven crazy by his touch. That is because they have said: “Sale is but Riba” while Allah has permitted sale and prohibited Riba.”¹

Non-Compliance with Shari’a:

The contract of *Riba* is described as being “non Shari’a compliant”. The term “Shari’a” as defined by Ikramur Rahman & Imad Ali is:

“Shariah literally means the path to the watering place. In technical and legal usage, however, Shariah refers to the commands, prohibitions,

1. See Pg. 90 of Noble Quran by Sheikh Taqi Usmani; published by Maktaba Ma’ariful Quran (Karachi).

guidance and principles derived from the primary sources of Islam, the Quran and Sunnah.”

Hence Shari’a compliant product implies a product, which is acceptable from an Islamic perspective.

Assessment by Islamic Scholars:

In the 1920s, Islamic jurists initiated analysing the banking system, as prevalent in those times, against the principles of Shari’a. The results of these juristic assessments and studies were largely unanimous, wherein it was concluded that existing business banking practices are in conflict with *Shari’a* principles because the core activity of any conventional bank is to borrow and to lend money against interest.

Pioneering Efforts:

In 1963, *Dr. Ahmad Elnaggar* (an Egyptian economist) started the Mit Ghamr Local Savings Fund, which was the world’s first saving bank free from interest dealings. The bank was functioning on a basic model. In later years, the bank was closed¹.

In March 1975, **Dubai Islamic Bank** was established in the UAE as world’s first Shari’a compliant commercial bank. The same year, **Islamic Development Bank** was established in Saudi Arabia as world’s first Shari’a compliant development bank. Both the banks are functioning till date.

1. Islamic Banking: Principles and Practices by *M. Imad Ali & Ikramur Rahman*; published by Marifa Academy (India).

Shari'a Guidance to Banks:

As a part of corporate governance, every bank runs its business under the guidance of its Board of Directors and other regulatory autonomous bodies or committees. This kind of corporate governance provides the general public with a sense of confidence and reliability about bank's direction and operations. Additionally, it creates a sense of accountability of the bank towards the shareholders of the bank. Correspondingly, the Islamic banks are no exception as regards these requirements.

However, Islamic banks, also, function in combination under the guidance of its **Shari'a Supervisory Board**, which is an independent body consisting of reputed Shari'a scholars who guide the bank on its Shari'a affairs. Some Shari'a scholars who had contributed immensely in this field are *Sh. Mohammad Taqi Usmani, Dr. Abdulsattar Abu Guddah, Dr. Hussain Hamid Hassan, Sh. Nizam Yaqubi, Dr. Ali Elgari, Dr. Daud Baker, Dr. Youssef Shubaili, Sh. Essam Eshaq.*

Emerging Markets for Islamic Banking:

We can define, emerging markets in Islamic banking as any economy where Muslims community are part of the local population and have not been offered so far any Islamic banking products, either in the retail or corporate segment.

As per the World Islamic Banking Competitiveness Report, the current size of international Islamic banking industry is US\$ 882

Billion¹. However, this figure can further increase if Emerging Markets are appropriately tapped by offering Shari'a compliant products and services to the local Muslim population.

Country	Muslim Population
India	183,000,000
China	22,000,000
Russia	9,400,000
Italy	2,220,000
Albania	1,879,172
Nepal	1,253,000
Netherland	825,000
Argentina	784,000
Austria	573,876
Georgia	442,000
Cyprus	273,000
Brazil	35,167
Chile	2,894
Liechtenstein	2000
Total Emerging Market	222,690,109

Source: *Wikipedia*

1. World Islamic Banking Competitiveness Report (2016) by Ernest & Young.


The above table clearly shows that the untapped Emerging Markets have more than 200 Million potential Muslim customers. Statistically, based on a conservative assumption of considering only 40% of a society as bankable, a minimum of 85 Million (from the above statistics) potential new customers can be leveraged to offering Shari'a compliant products. This will, certainly, result in higher levels of economic inclusiveness, where Muslim investors would be ready for an opportunity to invest their funds in Shari'a compliant deposits and, in return, get financings through organic banking offering.

PART 2:


Thumb-rules of Islamic Banking

Islamic banking products are developed post intensive brainstorming involving a mandated observation of specific thumb-rules to avoid committing any Shari'a violation or non-compliance. Some of these thumb rules are listed below:


No. (1): No Interest Income

Any Shari'a compliant product cannot involve payment or receipt of interest. This feature cannot be compromised even under the adverse circumstance of the financier bank potentially incurring huge losses in the business opportunity. 

No. (2): Based on Shari'a Contracts

Any Islamic banking product must be necessarily based on a Shari'a compliant contract, which has a pre-defined set of rights and obligations. Additionally, in complex products, more than one contract is used to serve the customer's financial needs. 

No. (3): No Late Penalties

A financier cannot charge late payment penalty as an extra income. Default interest is akin to claiming *Riba* (usury) and irrespective of the nominal nature of the amount for late payment 

penalty, it is not acceptable from Shari'a perspective.

No. (4): No Prohibited Items

As per Shari'a, certain products and services are prohibited, which cannot be financed either directly or indirectly. These items include pork, liquor, unlicensed arms, pornography products, drugs, and narcotics.



Thumb-rule (5): Observe Marketing Norms

Managing reputational risk is extremely important while marketing Shari'a compliant products. Hence promotional advertisement images and audio clips should mandatorily abstain from depicting any imagery or content, which might be objectionable or prohibited as per Shari'a.



PART 3:

Myths about Islamic Banking

Looking at the development of Islamic banking industry (in the Arabian Gulf Region and Malaysia) over the past four decades, it is evident that Shari'a compliant banking products have proven to be highly diversified as well as innovative in nature. These products could address financial needs and service not only simple but also complex banking needs of customers in a Shari'a compliant way.

Alternatively, it was observed that the majority of people in Emerging Markets remain misinformed about the real functionality of Islamic banking system and its various offerings. This lack of knowledge has led to mushrooming of several myths about what the Islamic banking can do or cannot! Some of such myths are highlighted below:

Myth 1: For Muslims, by Muslims

Many-a-times, people assume that Islamic banking is exclusively “for the Muslims”. However, it's a wrong assumption that non-Muslims cannot avail of Shari'a compliant products. Islamic banking never ignores non-Muslims since they are an integral part of any secular and cosmopolitan economy.

Moreover, it is also assumed that Islamic banking has been “by the Muslims” wherein products and service cannot be offered by a non-

Muslim workforce. This is also a myth. It needs to be highlighted that in case qualified non-Muslim individuals are interested in mastering the art of Islamic banking than they are welcome to join the industry. It has been observed that during the past few decades, many non-Muslim have gained an experience in the Shari'a compliant structuring and product development. Also, many non-Muslim academicians have specialized in teaching and writing about Islamic banking. It should be mentioned that positions in the internal Shari'a departments are exclusively reserved for practicing Muslims, qualified in Islamic studies and Arabic language.

Myth 2: Risk of Additional Loss

Islamic banks, usually, receive deposits via Mudaraba Deposits¹, which is a form of participatory investment. However, this does not indicate that all the financing products of Islamic banking should have a higher degree of partnership risk, wherein the financier potentially might have to face unmanageable risk.

In conventional banks, the risk appetite in offering commercial banking products (i.e. offered in retail and corporate) is lesser than the risk appetite shown in offering investment banking products. The same variation exists in Islamic banking industry. Hence, Islamic commercial banks prefer to provide Shari'a compliant

1. See Page 82.

alternatives to existing conventional banking products, such as loans, overdraft or credit cards. Correspondingly, investing an amount of money with the customer on Mudaraba is extremely risky. Hence Islamic banks avoid offering such products.

Myth 3: Financing Rate cannot be Fixed!

It is a general myth about Islamic banking products that financing rates should be variable to make it Shari'a compliant! Also, it is assumed, wrongly, that if rates are fixed then it is as good as loan offered by a conventional bank.

No doubt, it is a Shari'a violation if parties to a Shari'a compliant investment arrangement (like Musharaka or Mudaraba) agree on a pre-determined amount of profit irrespective of the actual performance of the business venture or partnership. However, in a trade contract (like sale or lease) it is a MUST to state the exact price or rent of the subject of the contract. Since Islamic banks rely mostly on sale and leasing contracts in their financings, so Islamic banks must prefix the rate of profit in any sale contract executed with its customer.

Myth 4: Islamic Banking More Expensive!

Many people argue that Islamic banks often exploit their customers' religious preferences by offering them financing products, which are over-priced in comparison with conventional products. There is no denying the fact that for several years Islamic banking products were priced in a less

competitive way. This trend could be attributed to the novelty of such products and not to deliberate financial exploitation by the Islamic banks. Another reason for over-pricing was inexperienced practitioners who were unaware about utilizing the best and most efficient pricing mechanism.

In the current scenario, Islamic banking products (especially in the Arabian Gulf region) are thoughtfully priced to ensure that they are as competitive as other conventional banking products. In fact, some Islamic banks offer auto finance products, which are cheaper than conventional banking products.

Myth 5: Islamic Banking is safer!

Some over-enthusiastic Muslims economists have defended the need for Islamic banking by marketing it as safer than the conventional banking in entirety.

Firstly, the short history of Islamic banking is an undependable empirical evidence to conclude that Islamic banking is safer than conventional banking. Certainly, only with the passage of time and change in demographic, as well as, eco-political factors, would it be evident if a banking model is 100% safe.

Secondly, the claim of being safer is mostly based on the assumption that Islamic banks continue holding on to, only, tangible assets and do not create debts, as is the case with conventional banks. Unfortunately, this assumption is not true in all the cases and particularly in liquidity

management products. It is true that no one can argue over Shari'a permissibility of these products. However, no one can, also, overlook the economic outcome of such products, which might mirror the outcome of conventional banking products.

Thirdly, it is argued that Islamic banks remained unaffected by the Sub Prime crises, which started in the year 2007 due to excessive use of conventional derivatives. Although this argument may seem valid on the face of it, in the past few years, efforts were made by international banks to launch Shari'a compliant derivatives, to hedge against unwarranted risk. In case Islamic banks start considering these products as an investment tool then their fate might be no different from conventional banks, which suffered during the Sub-Prime crises.

Hence, it is essential to consider the overall economic-cum-Shari'a utility of developing a Shari'a compliant product prior to making it available to the end-users.

Myth 6: Economic Rescuer!

Some people claim that the introduction of Islamic banking in Emerging Markets could solve all the domestic economic crises, especially, the crises arising due to agricultural financing. Such claims are either innocent or somehow unrealistic.

It's a fact that Islamic banks in Sudan have successfully deployed different forms of participatory agricultural financing, like *Muzarra*, *Musaaqa*, *Mugarasa*, etc. However, it would be an

exaggeration to claim that all the economic crises of the Emerging Markets will vanish if Shari'a compliant modes of financing are deployed by the domestic banks. No doubt, the major benefit of introducing Shari'a compliant products in Emerging Market is achieving macroeconomic inclusiveness by addressing the specific banking and financing needs of the Muslim population.

Myth 7: Different Macroeconomic Impact!

It is argued that end-result and over-all impact of introducing Shari'a compliant products is often (if not always) different from the macroeconomic impact of conventional banking products.

This argument can be accepted only on the basis of the premise that Islamic banks function in a stand-alone economic model with no presence of conventional banks. Moreover, this argument will also hold true when Islamic banking becomes a part of the greater economic system where addressing needs of social welfare and microfinance are the key goals of the overall macroeconomic system.

In the current scenario, Islamic banks are far lesser in numbers and are far smaller in size compared to the conventional banks. The need of the hour is to achieve microeconomic inclusiveness for a segment of the economy, which is bankable but remains untapped due to lack of Shari'a compliant offerings.

Myth 8: No Cash Financing

As per Shari'a, it is not permitted to earn money on money, i.e. earning interest on cash advances is absolutely prohibited. However, this does not imply that Islamic banks cannot endeavour to develop innovative Shari'a compliant products, which classify as liquidity solutions for retail, corporate, treasury sector customers. Moreover, solutions like Shares Murabaha¹ or Nasdaq Murabaha² have proven to be efficient Shari'a compliant solutions in addressing needs of liquidity management.

Myth 9: Hedging Not Permitted

All trade contracts in Shari'a involve an asset-based risk. However, this does not mean that any kind of risk hedging is impermissible by Shari'a. Minimization or mitigation of risk does not mean nullifying the same.

In fact, it is advisable as per Shari'a to mitigate the risk associated with any trade transaction - provided such tools and techniques are within Shari'a framework and compliant with the Shari'a principles.

Similarly, there is a general perception that as per Shari'a a debt cannot be sold by any means or ways. Although the outright sale of debt is not allowed, but debt can be passed on to a third party through the commoditized sale of debt³. During the

1. See Page 65.

2. See Page 68.

3. Refer to Resolution No. (1) of the Sixteenth Session of Fiqh Academy (Makkah).

money crunch, the financier can raise quick liquidity against his long-term Murabaha receivables via the commoditized sale of debt.

Myth 10: Late Payment has no Solution

As per Shari'a, once a sale contract is executed then any outstanding amount becomes a debt wherein the seller-on-credit has no Shari'a right to increase the price in the future. In case the customer delays settling the price then, as per Shari'a, no penalty interest can be charged.

Unfortunately, historically Islamic banks observed that a majority of their customers exhibited a misuse of the above Shari'a requirements by deliberately delaying their payments. So, what could be the possible solution to tackle this?!

Shari'a scholars suggested incorporating a condition in the sale contract whereby the buyer-on-credit undertakes to donate (via Islamic bank) a specified amount to charity if he delays in settling his payments on time. Such a condition acts as hammer clause, which ensures that the customer does not purposefully delay his payments. Islamic bank's inability to benefit from any amount paid to charity makes this condition different from default interest.

PART 4:

Hurdles of Islamic Banking

The Emerging Markets on perusal of dozens of product offerings of Shari'a-compliant banks across the world are naturally faced with the question: **“What could be the major hurdles of offering Shari’a compliant products in Emerging Markets?”**

Hurdle (1): Prohibition of Trading

Clause 8 of Indian Banking Act states the following:

“8. Prohibition of trading.

Notwithstanding anything contained in Sec. 6 or in any contract, no banking company shall directly or indirectly deal in the buying or selling or bartering of goods, except in connection with the realization of security given to or held by it, or engage in any trade, or buy, sell or barter goods for others otherwise than in connexion with bills of exchange received for collection or negotiation or with such of its business as is referred to in Cl. (i) of sub-section (1) of Sec. 6: 4 [Provided that this section shall not apply to any such business as is specified in pursuance of Cl. (0) of sub-section (1) of Sec. 6.]

Explanation. —For the purposes of this section, "goods" means every kind of movable property, other than actionable claims, stocks, shares, money, bullion and specie, and all instruments referred to in Cl. (a) of sub-section (1) of Sec. 6.”

Hence, if banks in Emerging Markets are not exempted from the above restriction then almost none of the Shari'a compliant products, based on sale or lease contract, can be offered under the existing regulatory framework.

One of the quick-fix solutions to this restriction is to start offering Shari'a compliant products, which involve credit sales of financial securities, like shares or Nasdaq Certificates.

Hurdle (2): Sale Tax Exemption

Considering the geographical presence of Islamic banking, it is evident that the Islamic banking industry till recently has been mainly concentrated in the Middle East and Malaysia, where either no sales tax existed or its requirements were duly amended for Islamic banks. However, it was a major regulatory challenge to address the issue of sale tax levied on Shari'a compliant products offered by Islamic financiers operating in the United Kingdom. As per Belouafi & Chachi (2014): *“the UK government and regulators have attempted, through the addition of ‘Alternative Finance’ clauses to various Taxation Acts, to create an environment where IF players and their clients are not treated any differently to their conventional counterparties.”* This, also, included removal of double tax on mortgage financing offered by Islamic banks.

Exemption from sales tax seems to be a daunting challenge, which needs to be addressed prior to the introduction of the Shari'a compliant

products in Emerging Markets. It could be possible, at first instance, to introduce liquidity management solutions where sales tax (on the financier) can be adjusted against sales tax (on the customer) upon liquidation of financial securities by the customer.

PART 5:

Forms of Trade in Shari'a

As per Shari'a, the money lender cannot earn any revenues on the loaned amount. Alternatively, it is acceptable as per Shari'a to charge profit or rent in a trade or leasing contract.

The requirement of trading in an asset comes to light with the Shari'a maxim of: ***“The benefit of a thing is a return for the liability for loss from that thing...”***¹ which can be simplified as he who bears the risk, reaps the profits. Hence, if a trader assumes the risk of the underlying asset at the time of executing the sale contract then he can charge profit as per his wish.

As per Shari'a, the following are the most common trade contracts, which are used by most of the Islamic banks to offer Shari'a compliant products:

1. The Mejelle (Islamic Civil Code) by *Ottoman Empire*, published by A S Noordeen (Malaysia): Pg. 14.

Murabaha:

- i. It is a form of sale wherein a seller (“**Murabaha Seller**”) sells a Shari’a compliant asset (“**Murabaha Asset**”) to a purchaser (“**Murabaha Purchaser**”) against an agreed upon sale price (“**Murabaha Price**”).
- ii. Murabaha Price is an amount, which is an aggregate of the following two components:
 - a- The cost incurred by the Murabaha Seller in acquiring the Murabaha Asset (“**Murabaha Cost**”), and
 - b- The amount of profit, which is charged by the Murabaha Seller (“**Murabaha Profit**”).

It is stipulated that both the components of the Murabaha Price should be disclosed to the Murabaha Purchaser at the time of signing the Murabaha contract.
- iii. *Settlement of Murabaha Price:* In banking transactions, Murabaha Price is settled by paying EMIs or in a bullet payment at the end of the financing tenure. Sometimes, Murabaha Price is partially settled on the spot and the balance is settled on due dates. However, Murabaha Price can be settled, fully, on spot basis as well.
- iv. *The risk of Murabaha Asset:* Upon signing the contract, the risk of the Murabaha Asset is transferred from the Murabaha Seller to the Murabaha Buyer.
- v. *Banking Application:* Islamic banks use Murabaha in financing purchase of physical assets (vehicles, goods, etc.) or financial securities (like, shares or Sukuks).

Ijarah:

- i. Ijarah is a leasing contract, wherein one party (“**Lessor**”) leases the usufruct or ownership rights in a Shari’a compliant asset or services (“**Leased Asset**”) to a party willing to make use of the Leased Asset (“**Lessee**”) against an agreed upon amount (“**Ijarah Rent**”)
- ii. *Ijarah Rent*: The Lessee can settle the Ijarah Rent either on a periodic basis or in a bullet payment.
- iii. *Banking Application*: Islamic banks use Ijarah in financing purchase of fixed assets (like land or machinery) or rendering services, such as health treatment, education or travel.

Istisna:

- i. It is a form of sale contract wherein a seller (as “**Istisna Seller**”) sells a manufacturable good (“**Istisna Asset**”) to a party willing to purchase the Istisna Asset (“**Istisna Purchaser**”) for an agreed upon price (“**Istisna Price**”).
- ii. *Istisna Price:* At the time of signing the Istisna contract, the Istisna Seller takes into consideration the expected cost of manufacturing or constructing the Istisna Asset. The Istisna Price once agreed cannot be amended to benefit the Istisna Seller.
- iii. On the successful delivery of the Istisna Asset by the Istisna Seller as per the agreed specifications, the Istisna Purchaser is obliged to settle the Istisna Price as previously agreed in the Istisna contract.
- iv. *Banking Application:* Islamic banks use Istisna for financing purchase of under-constructed properties or purchase of made-to-order goods.

Mudaraba:

- i. It is a form of partnership contract wherein one party invests (called “**Rab Al Maal**”) its funds (“**Mudaraba Capital**”) with another party (“**Mudarib**”) which agrees to manage the Mudaraba Capital for the benefit of both the parties.
- ii. *The share of Profit:* The Mudarib is entitled to receive a portion of profits (once realized) as per the prior agreed upon percentage.
- iii. *Principal Protection:* Under Mudaraba arrangement, there is no guarantee of profit; also Mudaraba Capital is not protected. In case the Mudarib commits an act of negligence then ‘Rab Al Maal’ is entitled to claim the Mudaraba Capital.
- iv. *Banking Application:* Islamic banks use Mudaraba in receiving deposits from its customers.

Musharaka:

- i. It's a form of partnership wherein more than one party (collectively referred as "**Partners**") contribute their respective funds ("**Musharaka Capital**") for a profitable partnership ("**Musharaka Assets**").
- ii. Partners could contribute towards Musharaka Assets in cash or in kind - provided valuation estimate can be furnished for any asset in kind.
- iii. *Profit*: By the end of the partnership, Partners are entitled to receive their respective share in the actual profits (if any).
- iv. *Principal Protection*: Under Musharaka arrangement, there is no guarantee of profit; also Musharaka Capital is not protected. In case one of the partners commits an act of negligence then other partners are entitled to claim their respective Musharaka Capital.
- v. *Banking Application*: Islamic banks use Musharaka in project financing or in acquiring new investments.

PART 6:

Offerings of Islamic Banking

In the first two decades of its commencement, Islamic banking industry concentrated its efforts to develop basic Shari'a compliant alternatives to conventional banking products. However, over a period of time, Shari'a compliant products became more innovative and also retained their Shari'a glow.

Having said that, the question which any regulator, policy-maker, shareholder or consumer would ask is: ***“What can be offered through Islamic banking?”***

The following section highlights the most famous Shari'a compliant products, which are offered by Islamic banks in the Middle East. Shari'a compliant products offered in the UK or Malaysia might differ slightly, in terms of execution but their core features remain identical.

A. Retail & Corporate Banking

i. Asset Financing

The core business of any Islamic bank is to disburse financings in accordance with Shari'a. Receivables on these financings constitute the assets of the bank.

Islamic banks address customers' needs through the following solutions:

- 1- Auto Finance
- 2- Property Finance
- 3- Service Financing
- 4- Liquidity Management
- 5- Credit Card
- 6- Overdraft Facilities

1) Auto Finance:

The bank can finance the car purchase through **Auto Murabaha** or **Auto Ijarah**.

a- Auto Murabaha:

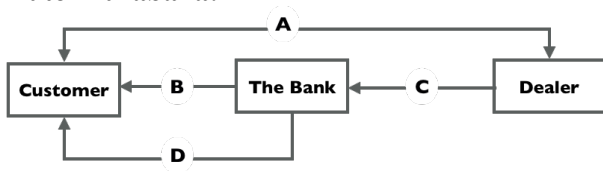


Figure 1: Auto Murabaha

Stage (A):

- *Price Quotation*: The customer raises a request for price quotation addressed to the bank through a car dealer (the “**Dealer**”).

Stage (B):

- *Application to Finance*: The customer applies for auto finance from the bank. The customer also undertakes to purchase the car once offered for sale on Murabaha by the bank.

Stage (C):

- *Issuance of the LPO*: The bank purchases the car via issuing LPO in the name of the Dealer.

Stage (D):

- *Murabaha Sale*: The bank sells the car to the customer by executing Murabaha Sale Contract.
- *Murabaha Price*: By signing the Murabaha Sale Contract, the customer agrees to settle the

Murabaha Price through EMIs payment on regular dates. Part of the Murabaha Price can be paid on spot.

- *Car Mortgage*: The car sold on Murabaha remains mortgaged in favour of the bank till all the EMIs are fully settled.

Strengths:

- i. *Standard Offering*: Auto Murabaha is one of the most common Shari'a compliant financing products used by, almost, all the Islamic banks across the regions.
- ii. *Car Insurance*: The Customer is supposed to obtain insurance of the car. In case the car is destroyed post signing the Murabaha contract then the customer remains liable to settle the outstanding Murabaha Price.

Challenges:

- i. *Exemption from Trade Prohibition*: Since Auto Murabaha involves sale and purchase of the vehicle, offering such a product in Emerging Market will require an exemption from the trade prohibition as applicable to the conventional banks.
- ii. *No Change in Profits*: The Murabaha Profit remains fixed throughout the financing tenure. In case the customer loses his job or defaults then the bank has no Shari'a right to claim higher Murabaha Profits.

b- Auto Ijarah:

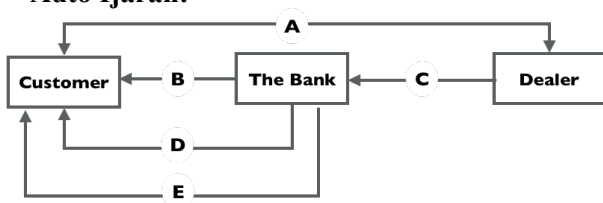


Figure 2: Auto Ijarah

Stage (A):

- *Price Quotation*: The customer raises a request for price quotation addressed to the bank through a car dealer (the “**Dealer**”).

Stage (B):

- *Application to Finance*: The customer applies for auto finance from the bank. The customer also undertakes to enter into Ijarah contract once the car is offered for Ijarah lease by the bank.

Stage (C):

- *Issuance of the LPO*: The bank purchases the car by issuing an LPO addressed to the Dealer.

Stage (D):

- *Ijarah Contract*: The bank leases the car on Ijarah basis to the customer.
- *Ijarah Rent*: The customer (as lessee) agrees to settle Ijarah rental through the payment of EMIs on regular dates.

Stage (E):

- Once all the EMIs are duly settled then the bank can transfer the car to the customer either as a gift or by selling it for a nominal price to the customer.

Strengths:

- i. *Variable Returns:* The financing rate of Ijarah can be variable because rent for the coming lease periods can be changed with the mutual consent of the contracting parties.

Challenges:

- i. *Car Insurance:* Since the bank acts as a lessor so it should continue to bear the risk of the car through the lease tenure. In case the car is destroyed prior to settling all the EMIs then the bank would suffer financial loss, which will be equal to the entire Ijarah rental for the coming period.
- ii. *Exemption from Trade Prohibition:* Since Auto Ijarah involves sale, purchase, and lease of vehicles so offering such a product in Emerging Market will require an exemption from the trade prohibition as applicable to the conventional banks.

2) Property Finance:

The bank can finance the purchase of a property through various Shari'a compliant modes of financing like *Istisna*, *Ijarah*, *Musharaka*. Each of these arrangements would reflect the way the bank is interested in taking ownership of the financed asset. However, the core product (or contract), which allows Islamic banks to claim returns over the financed property is **Ijarah**. Although, Property Murabaha (like Auto Murabaha) can also be deployed but it has limited application due to the fixation of the profit rate throughout the financing tenure, which can even go up to a period of 30 years.

a. Property Ijarah:

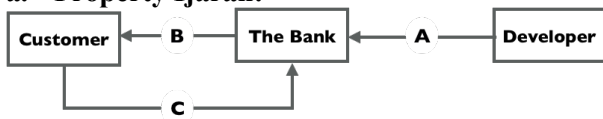


Figure 3: Property Ijarah

Stage (A):

- *Property Acquisition*: The bank acquires ownership of a property (i.e. Ijarah Asset) through purchasing the same from a developer or an individual.

Stage (B):

- *Ijarah of the Property*: The bank leases the property on Ijarah basis to the customer.
- *Rent Settlement*: The customer agrees to settle Ijarah rental through the EMIs payment on a

regular basis. Usually, Islamic banks link the Ijarah rent to a benchmark like LIBOR or any index rate used by the local industry.

Stage (C):

- Once all the EMIs are duly settled, then the bank can transfer the property to the customer either as a gift or by selling the property to the customer for a nominal price.

Strengths:

- i. *Variable Returns:* The financing rate of Ijarah can vary because rent for the coming lease period can be altered with mutual consent of the contracting parties.

Challenges:

- i. *Property Insurance:* Since the bank acts as a lessor so it should continue to take risk of the leased property. In case the property is destroyed prior to the settlement of all the EMIs then the bank might suffer financial loss equivalent to the entire Ijarah rental for the coming period.
- ii. *Exemption from Trade Prohibition:* Since Property Ijarah involves sale, purchase, and lease of property, therefore offering such products in Emerging Market will require an exemption from the trade prohibition as applicable to the conventional banks.

3) Service Financing:

In consumer banking, if the customer is looking for financing of education, travel plans, health treatment or short term stay (“**Service**”) then Islamic banks usually offer **Service Ijarah**, as given below.

a- Service Ijarah:

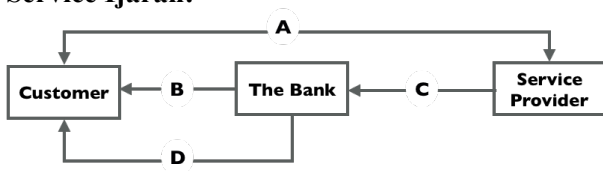


Figure 4: Service Ijarah

Stage (A):

- *Price Quotation*: The customer raises a request for price quotation addressed to the bank through a service provider (the “**Service Provider**”).

Stage (B):

- *Application to Finance*: The customer applies for service financing from the bank. The customer also undertakes to enter into Ijarah contract once the service is offered by the bank.

Stage (C):

- *Issuance of the LPO*: The bank acquires the service (as requested by the customer) by issuing the LPO addressed to the Service Provider.

Stage (D):

- *Ijarah of Services*: On signing the LPO, the bank allows the customer to make use of the service based on the Ijarah contract as signed with the customer.

Strengths:

- i. *Semi-variable Returns*: The bank may change the subsequent financing rate of Ijarah for the portion of service which was not utilized by the customer. For example, during the first year of education, the bank may agree with the customer to revise the Ijarah rate for the second year of education. Once the respective lease period commences then no change in the financing rate is acceptable. Similarly, no change in the financing rate of travel financing is possible once the customer has used the travel tickets.

Challenges:

- i. *Warranty of Services*: In case any issues arise in terms of the service delivered by the Service Provider then the Bank remains liable to provide an alternative service (as agreed in the Ijarah contract) to the customer. It is acceptable, although, for the bank to authorize the customer to pursue any disputes directly with the Service Provider on behalf of the bank.
- ii. *Exemption from Trade Prohibition*: Since Service Ijarah involves leasing and subleasing

of the services, therefore offering such a product in Emerging Market will require an exemption from the trade prohibition as applicable to the conventional banks.

4) Liquidity Management:

One of the biggest challenges to any Islamic bank is to develop Shari'a compliant solutions for personal finance (in retail banking) and short-term liquidity solutions (in corporate and treasury).

Challenges:

There are two reasons which contribute to the complicity of liquidity management solutions:

- i. *Liquidity of the Underlying Asset:* As evident, any financing arrangement in Shari'a compliant banking requires sale and purchase of a tangible asset. This means that if any tangible asset is sold by an Islamic bank to facilitate liquidity generation, then such asset should be highly liquid on the transfer of its ownership to the purchasing customer. It is common knowledge that not all the assets are liquid.
- ii. *Price Volatility of the Underlying Asset:* Simultaneously, the bank aims to ensure that price volatility of the underlying asset (in a Shari'a compliant liquidity arrangement) is manageable or at least bearable. Otherwise, the customer might suffer due to sudden price changes of the underlying asset.

a. LME Murabaha:¹

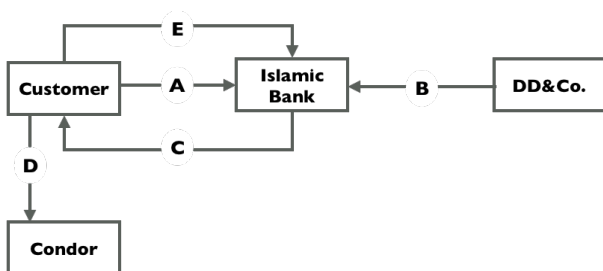


Figure 5: LME Murabaha

Stage (A):

- The customer raises a request for a personal finance from the bank.

Stage (B):

- *Spot Purchase*: The bank purchases LME Metals from DD&Co., which is a known metal supplier based in London (UK).

Stage (C):

- *Murabaha Sale*: The Bank sells LME Metals to the customer on Murabaha basis. The customer agrees to settle the Murabaha Price through EMIs payment on regular dates.

1. London Metal Exchange (“LME”) is a renowned metal exchange based in London (UK) where forwards and options contracts of metal are traded on daily basis. LME Murabaha transactions (as carried out by Islamic banks) are never routed through LME. Rather such metals which are fully allocated through Holding Certificates and stored in LME warehouses (“LME Metals”) are used in Shari’a compliant financing based on Murabaha sale.

Stage (D):

- *Spot Sale*: The customer appoints the bank as his agent to sell LME Metals (purchased by him) to Condor Trade Ltd., which is another LME Metal supplier based in London.

Stage (E):

- On Condor Trade Ltd.'s purchase of the LME Metal sold by the customer, the sale proceeds are transferred into customer's specified account via bank.

Strengths:

- *Replica of Standard Offering*: LME Murabaha replicates the existing liquidity management solutions offered by conventional banks in terms of credit risk and financial outcome. In addition, the bank does not take risk of the underlying asset throughout the financing period. Although in LME Murabaha, it is necessary to ensure that the bank conducts the purchase and sale of the metals in accordance with the specified Shari'a requirements.

Challenges:

- i. *Exemption from Trade Prohibition*: Since LME Murabaha involves the sale and purchase of metals, therefore offering such a product in Emerging Markets will require an exemption

from the trade prohibition as applicable to the conventional banks.

- ii. *No Change in Profit:* Murabaha profit is final and cannot be changed once it is agreed upon between the bank and the customer.
- iii. *Complex Arrangements:* LME Murabaha is a complex transaction, which runs over various legal jurisdictions and is conducted across many steps. Also, it is worth mentioning that LME Murabaha is not accepted by some Shari'a Boards since it is a form of Organized *Tawarruq* (monetization), which has been critically examined in various forums and academic papers.

b. Shares Murabaha:

Shares Murabaha was introduced by Islamic banks as a liquidity management solution with higher operational efficiency and was designed to address Shari'a rights of the purchaser in a better way. The customer has wider choices in Shares Murabaha, than LME Murabaha, in terms of holding the Murabaha Asset or selling it directly to a third party.

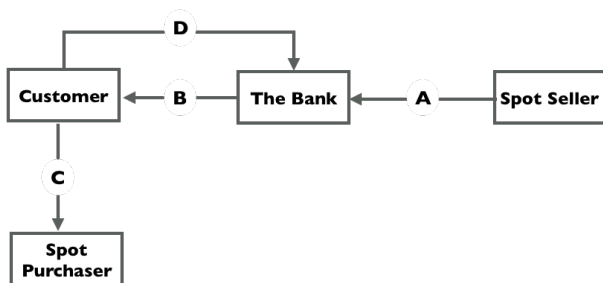


Figure 6: Shares Murabaha

Stage (A):

- *Spot Purchase*: The bank purchases, on its own behalf, public listed shares, which qualify to Shari'a requirements of financial screening¹. This purchase can take effect through any brokerage house.

1. Refer to S&P Dow Jones Islamic Market Index to further understand Shari'a requirements of permissible shares.

Stage (B):

- *Murabaha Sale*: The bank sells the purchased shares to the customer on Murabaha basis. The customer agrees to settle the Murabaha Price through EMIs payment on regular dates.

Stage (C):

- *Spot Sale*: Once Murabaha is concluded as per Stage (B) then the customer is entitled to any of the following:
 - a. Hold the purchased shares,
 - b. To sell the shares through any of the brokerage houses.

Stage (D):

- The customer pays the EMIs to the bank on regular basis.

Strengths:

- i. *Controlled Risk*: Once shares are transferred to the customer's custody account then the bank (as Murabaha Seller) will not continue to bear any risk associated with the shares.

Challenges:

- i. *Exemption from Trade Prohibition*: Since Shares Murabaha involves sale and purchase of shares, therefore offering such a product in Emerging Markets will require an exemption from the trade prohibition as applicable to the conventional banks.

- ii. *High Price Volatility*: Usually shares with high liquidity will have high price volatility. Hence, the customer (as Murabaha Buyer) might suffer huge and unexpected financial loss if he holds the purchased shares for some time. There are, also, chances that the customer may make a good fortune if markets are bullish and the prices move upwards.
- iii. *No Change in Profit*: Murabaha Profit cannot be increased once it has been agreed upon between the bank and the customer.
- iv. *Trading Book Restrictions*: In some markets, the regulators impose a limit on the daily purchase order, which can be placed by any financial institution. Certainly, in huge volumes deals, it would be difficult to abide by such regulations.

c. Nasdaq Murabaha:

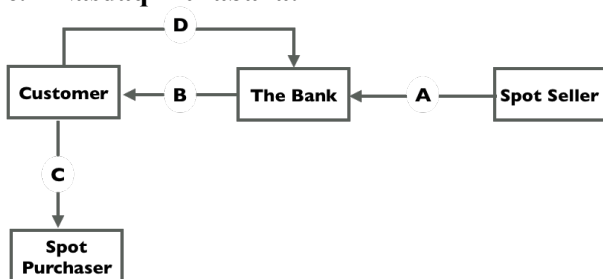


Figure 7: Nasdaq Murabaha

In 2013, Emirates Islamic Bank (a Dubai-based Islamic bank) introduced **Nasdaq Murabaha**, which is an innovative Shari'a compliant liquidity management solution that was launched in association with Nasdaq Dubai. The solution is based on Murabaha sale of exchange-listed certificates ("**Nasdaq Certificates**") which are backed by the Shari'a compliant assets, like shares, Sukuks (Islamic bonds), short-term financings, real estate, etc. Nasdaq Certificates are 100% liquid and offer an additional benefit of affordable pricing and zero price volatility in the short-term. The value of each Nasdaq Certificate is USD 10/-. The Nasdaq Certificates platform has expanded to USD 500 Million and is able to accommodate transactions for retail, corporate, FIs and, even, complex deals, such as Sukuks (Islamic bonds) and syndication.

Stage (A):

- *Spot Purchase*: The bank purchases Nasdaq Murabaha Certificates from the Spot Seller through a brokerage firm.

Stage (B):

- *Murabaha Sale*: The bank sells Nasdaq Certificates on Murabaha basis to the customer. The customer agrees to settle the Murabaha Price through EMIs payment on regular dates.

Stage (C):

- *Certificate Liquidation*: Once Murabaha is executed as per Stage (B) then the customer is free to hold Nasdaq Certificate until maturity or he may sell the purchased Nasdaq Certificates (via a brokerage firm) to a third party to generate liquidity. The customer, in all the cases, cannot appoint the bank as his agent, or messenger, to sell or liquidate the purchased Nasdaq Certificates.

Stage (D):

The customer pays the EMIs to the bank on regular basis.

Strengths:

- i. *Balancing the Liquidity and Volatility*: Explicitly, Nasdaq Certificates strike a good balance between the urgency of liquidity and avoidance of price volatility.

Challenges:

- i. *Exemption from Trade Prohibition:* Since Nasdaq Murabaha involves sale and purchase of Nasdaq Certificates, therefore offering such a product in Emerging Markets will require an exemption from the trade prohibition as applicable to the conventional banks.
- ii. *No Change in Profit:* The Murabaha Profit cannot be increased once the profit is agreed upon between the bank and the customer.

5) Bank Cards:

Islamic banks offer a full range of cards like a debit card, charge card, credit card, with the latest addition of a new category called the **covered card**.

a. Debit Card & Charge Card:

Shari'a compliant debit card or charge card is very similar to transaction cards offered by conventional banks as both the cards do not involve payment or receiving interest.

b. Credit Card

Stage (A):

- *Loan*: The bank extends an interest-free loan to the customer. The loan amount is equal to the credit limit requested by the cardholder.

Stage (B):

- *Fee for Services*: The bank charges a monthly membership fee for a variety of services and benefits, which can be availed through the credit card, like valet service, access to airport lounges, air-ticket booking, etc.

Stage (C):

- *Waiver vs. Charge*: In case of a complete settlement of the outstanding amount on the card, the bank may waive 100% of the monthly fee. Otherwise, the bank will levy charges of the membership fee on monthly basis.

Strengths:

- No Regulatory Change*: Such a product offering does not require an exemption from the prohibition of trade, which is applicable to the conventional banks.

Challenges:

- Standard vs. Charged Fee*: In certain circumstances, the services offered on the card are over-priced as compared to their market price.

c. Covered Card

It is a form of a Shari'a compliant card where the customer enters into a Murabaha contract with the bank at the time of applying for the card. It is described as **covered** because the card limit is fed by the sale proceeds of an asset bought by the cardholder on Murabaha basis.

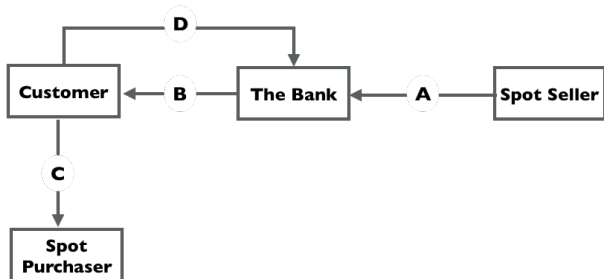


Figure 8: Covered Card (Murabaha)

Stage (A):

- *Spot Purchase*: The bank purchases Murabaha Asset (either commodities, shares or Nasdaq Certificates) from a Spot Seller.

Stage (B):

- *Murabaha Sale*: The bank sells the Murabaha Asset (as acquired in Stage (A)) on Murabaha-basis to the prospective cardholder.

Stage (C):

- *Spot Sale*: Post executing the Murabaha contract with the bank, the cardholder can sell the Murabaha Asset to a Spot Purchaser who must be different from the bank.

Stage (D):

- *Fund Transfer*: On the sale of Murabaha Asset by the cardholder, he may deposit the sale proceeds with the bank on the basis of Mudaraba, Wakala or Facility on Demand.
- *Profit Payment*: The bank retains the right to claim from the cardholder full (or part of) Murabaha Profits. This claim will be based on actual limit utilization and the remaining profit is either netted off against the Mudaraba profits (payable to the customer) or discretionarily waived by the bank (in the case of Facility on Demand).

Strengths:

- i. *Identical Profit Calculation*: In the context of system perspective the Murabaha Profit mechanism is like interest calculated on credit cards. This makes it easier for conventional banks to start offering Shari'a compliant cards in a short span of time.

Challenges:

- i. *Exemption from Trade Prohibition*: Since Covered Card involves sale and purchase of a Shari'a compliant asset, therefore offering such a product in Emerging Markets will require an exemption from trade prohibition as applicable to the conventional banks.

- ii. *No Change in Profit:* Murabaha Profit cannot be increased once it has been agreed upon between the bank and the cardholder.

6) **Overdraft facilities:**
a- **Islamic Covered Drawing (Murabaha):**

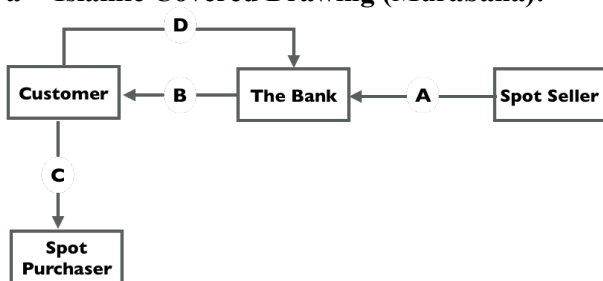


Figure 9: Islamic Covered Drawing

Stage (A):

- *Spot Purchase*: The bank purchases a Shari'a compliant asset on spot basis. The purchased asset could be shares, LME Metals or Nasdaq Certificates.

Stage (B):

- *Murabaha Sale*: The bank sells the Murabaha Asset (purchased as per Stage (A)) to the customer on Murabaha basis.
- *Murabaha Price*: The customer agrees to pay the Murabaha Price through a regular payment of the periodic Murabaha Profits. The principal of Murabaha will be settled as a bullet payment upon maturity.

Stage (C):

- *Spot Sale*: If the customer wishes then he may proceed further and liquidate the Murabaha Asset

either on his own, through the bank, or through a brokerage firm.

Stage (D):

- *Customer's Limit Creation:* On the sale of Murabaha Asset, the customer might credit the sale proceeds with the bank as a facility on demand (FOD) or as Mudaraba Deposit.
- In case the customer withdraws the entire amount available in his limit then the bank would claim the full amount of Murabaha Profit.
- In case the customer partially withdraws the amount available in his limit then the bank would charge him a portion of the Murabaha profit and the remaining will be either waived by the bank or adjusted against the Mudaraba Profit payable to the customer.

Strengths:

- i. *Flexibility in Fund Withdrawal:* There is no Shari'a requirement to execute Murabaha contracts whenever the customer requires funds on the basis of short notice.

Challenges:

- i. *Exemption from Trade Prohibition:* Since Islamic Covered Drawing involves sale and purchase of Shari'a *compliant* asset, therefore offering such a product in Emerging Markets will require an exemption from the trade prohibition as applicable to conventional banks.

- ii. *No Change in Profit:* Murabaha Profit cannot be increased once agreed upon between the bank and the customer.

b- Secured Overdraft (Mudaraba):

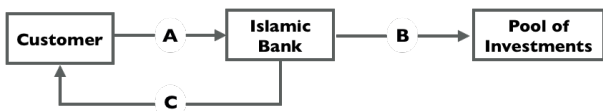


Figure 10: Secured Overdraft (Mudaraba)

Stage (A):

- *Placing Fixed Deposits:* The customer places Mudaraba Deposit with the bank. The customer is entitled to receive periodic returns on the Mudaraba Deposits.

Stage (B):

- *Credit Line:* The bank extends overdraft facility based on *Qard Hasan* (interest-free loan). The credit facility is, usually, equal or less than the value of the Mudaraba Deposits.

Stage (C):

- Based on the customer's actual usage of the credit line, the bank may adjust the profits distributed on the fixed deposits placed with the bank.

Strengths:

- i. *No Regulatory Change:* Offering overdraft facility (with zero profit) does not require any exemption from regulatory bodies in Emerging Market.

Challenges:

- i. *Mudaraba Deposits*: The bank should be able to manage *deposit* based on Mudaraba. This requires Shari'a compliant pool of investments.

ii. Deposit Products

The conventional bank receives funds in the following forms:

- 1- Fixed Deposits
- 2- Saving Accounts
- 3- Current Accounts

Balances in the current accounts do not attract any interest income for the account holder, whereas saving accounts and fixed deposit are interest bearing accounts.

These accounts are classified as “**Liabilities**” because it’s a liability on any bank to refund (or pay-back) the deposited money whenever demand is made by the depositor.

Correspondingly, Islamic banks receive deposits under the same accounts as given above. And the product offering for these deposits are:

- a) Mudaraba Deposit
- b) Murabaha Deposit
- c) Current Accounts

a- Mudaraba Deposits:

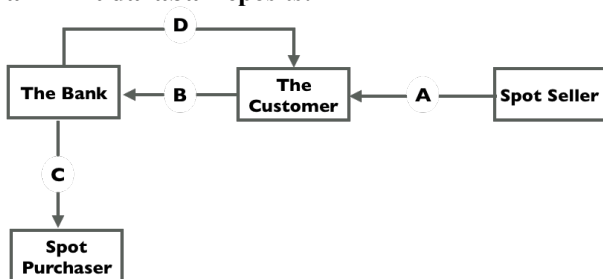


Figure 11: Mudaraba Deposits

Stage (A):

- The account holder (as *Rab Al Maal*) places funds on the Mudaraba basis with the bank (as Mudarib).
- *Profit Benchmark*: The bank may inform the account holder about the historic profit rates or the expected rate of profit on the Mudaraba accounts.

Stage (B):

- The bank invests these funds in a Shari'a compliant pool of investments and financings.
- *Profit Calculation*: Mudaraba profit is calculated on the daily weighted average basis.

Stage (C):

- *Principal Protection*: Under Mudaraba Deposit, there is no guarantee of profit, and Mudaraba Capital is not protected. In case the bank (as Mudarib) commits an act of negligence then the

customer (as Rab Al Maal) is entitled to claim the Mudaraba Capital.

- *Profit Distribution*: Upon the date of profit distribution, the bank distributes the actual profit as per the percentage of profit distribution.

Strengths:

- i. *Standard Offering*: Mudaraba Deposits are one of the most common Shari'a compliant deposit structure used by, almost, all the Islamic banks across the regions.
- ii. *Freedom to Deploy Funds*: The bank (as Mudarib) remains free to invest funds in various investments and financings which mandatorily comply with Shari'a.
- iii. *No Regulatory Exemption*: Offering Mudaraba Deposits does not require an exemption from trade prohibition because Mudaraba Deposits are a form of investment rather than buying or selling of an asset.

Challenges:

- i. *Shari'a compliant Pool*: In Emerging Markets, it would be difficult for banks, in the initial phases, to assure the depositors that funds will be invested in 100% Shari'a compliant assets. This can be attributed to the fact that if the bank fails to invest then any idle funds will generate no returns, which will cause a loss for the depositors.
- ii. *Misuse by the Mudarib*: In the absence of rigorous audit by regulatory authorities there

are chances of misuse by the banks (acting as Mudarib), which will claim that Mudaraba pool has suffered a loss without any misconduct from the bank. It is not possible for an individual depositor to check the authenticity of this claim.

b- Murabaha Deposits:

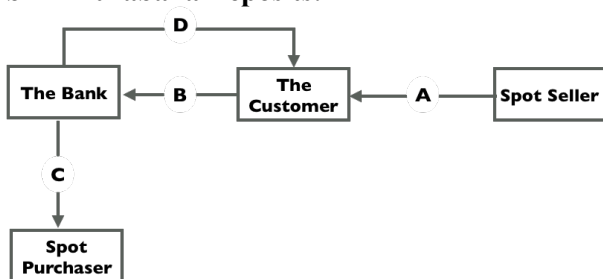


Figure 12: Murabaha Deposits

Stage (A):

- *Acquiring Murabaha Assets:* The customer purchases a Murabaha Asset from a spot seller (the “**Supplier**”) either directly from the Supplier or through appointing the bank as an agent to purchase on behalf of the customer.

Stage (B):

- *Murabaha Sale:* The customer sells the Murabaha Asset to the bank on Murabaha basis with deferred payment.
- *Profit Calculation:* The Murabaha Profit is calculated on daily basis irrespective of the bank’s financing portfolio performance.

Stage (C):

- *Spot Sale:* On the execution of Murabaha the bank may sell the Murabaha Asset to a third party (“**Spot Purchaser**”). Alternatively, the bank may continue to hold the Murabaha Asset.

- *Use of Funds*: On the liquidation of the Murabaha Asset, the bank is free to make use of the sale price (paid by the Spot Purchaser) as per bank's own investment choices, without the Shari'a requirement of running the Mudaraba pool of assets.

Stage (D):

- *Profit Distribution*: On the deposit maturity date, the bank credits customer's account with the agreed upon Murabaha Price, which is the sum of Murabaha Cost and Murabaha Profit.

Strengths:

- Guaranteed Profits*: Under Murabaha Deposits, payment of Murabaha Profits is guaranteed.
- Capital Protected*: Under Murabaha Deposits, Murabaha Capital is protected.

Challenges:

- Exemption from Trade Prohibition*: Since Murabaha Deposit involves sale and purchase of Murabaha Assets, therefore offering such a product in Emerging Market will require an exemption from the trade prohibition as applicable to the conventional banks.

c- Current Account:

- The customer (as the account holder) deposits funds with the bank on an interest-free basis.
- The bank is free to utilize these funds as per its operational needs or commercial plans.
- The customer has the right to claim the deposited funds whenever he wishes.
- No profit accrues on the balance available in the Current Account.

Strengths:

- i. *Identical Structure:* To a large extent the existing product offered by conventional banks is similar to the Shari'a compliant product, which is offered by Islamic banks.

Challenges:

- i. *No Prizes:* In accordance with Shari'a, balances in the current accounts are loans by the account holders to the bank. Hence, it is not permitted for the bank to distribute any raffle draw prizes on such accounts.

B. Treasury & Investment Products

Money Market:

Islamic banks receive funds from other banks either through LME Murabaha (referred in such case as **International Murabaha**) or through **Overnight Wakala** (wherein Islamic bank acts as an investment agent to invest). In case Islamic bank wants to place excess liquidity with conventional banks, it should be ensured that no funds are placed through Overnight Wakala or Mudaraba Deposits. Islamic banks may place funds with conventional banks only through International Murabaha.

Foreign Currency (FX) Transactions:

Islamic banks enter into **FX Spot** transactions which function, to a large extent, similar to the offering of conventional banks. As an additional requirement, Islamic banks do not allow short selling of currencies.

FX Forward in Islamic banks functions analogous to its functioning in conventional banks. However, promise to sell (or buy) a currency on a future date cannot be bilaterally binding.

Moreover, some international banks (e.g. Standard Chartered and HSBC) have come up with Shari'a compliant versions of **FX Options and FX Swaps** and most of these products are based on LME Murabaha¹.

1. For more details, a good reference on Islamic Derivatives is Financial Engineering in Islamic Finance by *Hussain Kureshi, Mohsin Hayat & Septya Iriani Mukshia*; published by Partridge (Singapore).

C. FIs & Investments:

MRPA: Since the past few years, Islamic banks have started to participate in the risk participation deals where credit exposure is shared with other participating banks. The standard agreements used by market players are duly modified to address any Shari'a issues, like participating in risk of the non-Shari'a compliant asset, the pledge of non-Shari'a compliant securities, obligation to pay default interest, etc.

Nostro Accounts: Islamic banks sign standardized agreements with international banks for opening of Nostro accounts. It is always ensured that no interest is charged on the Islamic banks' Nostro accounts in case these accounts go overdrawn. Also no interest is paid on the credit balance.

Sukuks: Islamic banks raise funds through Sukuks, which are Shari'a compliant alternative to bonds. In the past few years, Dubai, Kuala Lumpur, London have become world's centres in the process of Sukuk issuance. Sukuks have played a vital role in infrastructural development. Sukuks, which are based on Ijarah or Mudaraba are negotiable, i.e. tradable for a price as decided by demand and supply. Alternatively, Murabaha Sukuks are non-negotiable.

PART 7:

Roadmap in Emerging Markets

Phased Approach:

To achieve sustainable and long-lasting results, Shari'a compliant products should be introduced in a **phased approach**. Based on the other market experiences, Islamic banking can be introduced in the following phases:

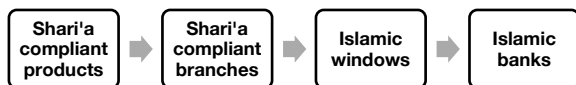


Figure 13: Phased Approach of introducing Islamic Banking

Phase (1): Shari'a Compliant Products:

In some economies (like the UK), Islamic banking was introduced by conventional banks through the offering of specific Shari'a compliant products, like mortgage finance.

Such a basic approach helps the regulators, accountants, banks, as well as customers, to experience the challenges of offering Shari'a compliant product on a large scale.

Phase (2): Shari'a Compliant Branches:

In the next stage, conventional banks can dedicate a specific branch to run its business in compliance with Shari'a. Usually, these branches are chosen in

areas, which are easily accessible for Muslim consumers.

This phase helps the operating banks to understand the dynamics of running a miniature pool of funds, which comprises of Shari'a compliant assets and liabilities.

Phase (3): Islamic Window

In the next stage, banks can establish Islamic windows, which offer Shari'a compliant products as well as services. Islamic windows are supposed to establish permanent **Shari'a committees**, which comprise of renewed independent Shari'a scholars who are well-versed with Shari'a rulings on financial matters.

In this stage, marketing identity of Shari'a compliant business needs to be further crystallized. Also, more responsibility is placed on the bank to ensure segregation of conventional businesses from the Shari'a compliant activities. And most importantly, the regulators and legal bodies during this phase will be exposed to a first-hand experience of any technical issues and basic requirements, which would have emerged post offering Shari'a compliant products.

Phase (4): Islamic Bank

Finally, once regulators, investors as well as consumers are ready to gain the complete experience of Islamic banking then full-fledged Shari'a compliant banks can be floated. In this phase, all the concerned parties would be entrusted with extensive duties to achieve smooth and seamless functionality. Most

importantly central banks would need to issue new licenses for Islamic banks wherein such organizations are exempted from trade-prohibition clause. Similarly, taxation authorities would need to initiate the process of exempting Islamic banks from the usual sale-tax, which might be levied on Murabaha sale or Ijarah leasing transactions.

The Sequence of Introduction:

It is not a pre-requisite for the introduction of Shari'a compliant products in any Emerging Market that local banks should go through Phase (1) then Phase (2) then Phase (3) to reach the apex of Phase (4).

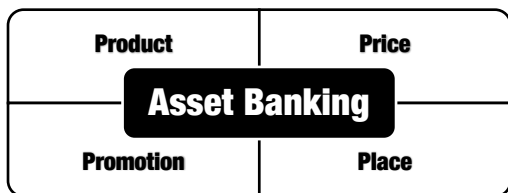
In fact, shareholders, as well customers, can directly gain the experience of Shari'a compliant products through moving to Phase (4). Irrespective of the movement direction, it is very crucial to iron out any pending issues (whether regulatory or accounting) prior to moving on to the next phase. Addressing all the issues and challenges of the present phase will raise the performance quality of the coming phase.

Marketing of New Products:

Once the policy-makers, as well as banks, decide to launch Shari'a compliant products in Emerging Markets then the following question naturally follows:

How can Shari'a compliant products be offered to consumers in Emerging Markets?

This could be done through addressing the standard and strategic questions in relation to:



1- PRODUCT

Correspondingly, the major question that immediately follows for banks in Emerging Markets is to identify the most suitable Shari'a compliant product for the customers.

Considering the major hurdles and challenges of launching standard Islamic banking products (e.g. Auto Murabaha or Mudaraba Deposits) in Emerging Market, it is suggested to initiate the process by offering products, which require lesser (or preferably no) changes in the existing regulatory framework as well as taxation laws. Liquidity management solutions (like Shares Murabaha or Nasdaq Murabaha) could be the first step in a long journey.

Product (A): Short Term Financing with Fixed Rate

In case an existing bank in a Emerging Market wants to extend a loan up to US\$ 50,000 then it can, alternatively, extend a Shari'a compliant financing, which can be offered based on Nasdaq Murabaha as given below:

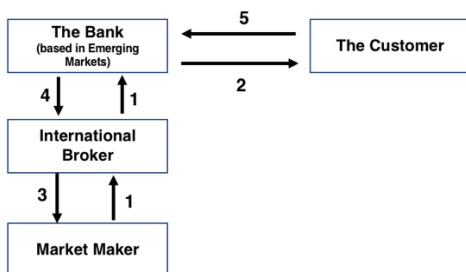


Figure 14: Basic Products of Emerging Markets

Stage (1): The bank will purchase Nasdaq Certificates¹ worth USD 50,000 through an international broker.

Stage (2): The bank will sell the purchased Nasdaq Certificates to its customer on Murabaha basis i.e. US\$ 50,000 plus standard profits. The customer has two choices a) to hold the purchased Nasdaq Certificates, or b) sell the purchased Murabaha asset when he wishes.

1. See Nasdaq Murabaha (Pg. 68).

Stage (3): In case the customer opts to sell Nasdaq Certificates then the international broker will sell them to the Market Maker.

Stage (4): The international broker will authorize the bank to credit sale proceeds to the customer's account once sale to the market maker is concluded.

Stage (5): On a monthly basis, the customer pays EMIs to the bank.

It is **worth mentioning** that:

- a- Since the above mechanics involve the sale of financial securities (e.g. shares or Nasdaq certificates) therefore the regulators of Emerging Market might not subject such a transaction to the restriction of Prohibition of Trade as applicable to other physical and tangible assets, like vehicle or real-estate.
- b- Accountants in Emerging Market can validate if any amount of sales tax levied in Stage (2) due to Murabaha sale between the bank and its customer can be offset against sales tax levied in Stage (3) due to the sale of financial securities by the customer.

Product (B): Home Finance for Non-residents:

Banks in Emerging Markets can tap a large segment of overseas customers who are willing to avail home financing in their home countries. The Shari'a compliant financing can be structured based on Shares Murabaha or Nasdaq Murabaha.

In other scenarios, banks in Emerging Markets can tie-up with overseas Islamic banks in providing ancillary services in a Shari'a compliant financing, which will include valuation of the financed property, management of mortgage, instalment recovery, etc.

2- PROMOTION

Often Shari'a compliant products are marketed as “*Islamic*”, “*Halal Products*” or “*Shari'a compliant*”. However, it is not a mandatory Shari'a requirement to brand Islamic banking products with these labels. For example, three full-fledged Islamic banks in the UAE do not use the word Islamic in their names. Similarly, in Saudi Arabia, no Shari'a compliant bank is branded as “Islamic”. In some markets (like Turkey and Morocco), Shari'a compliant banking is promoted as *participatory banking*.

Hence it is suggested that in Emerging Markets, the newly-introduced Shari'a compliant products can be branded as **Asset Banking Products** to avoid any image crises.

3- PLACE

Existing banks in Emerging Markets should be encouraged to offer Shari'a compliant products, which aim to achieve economic inclusiveness of Muslim population within the larger society.

International and foreign banks, which have their representative offices/branches in Emerging Markets, should be encouraged to enter into corporate deals with local customer base towards a widening of the development avenues for Shari'a compliant solutions. Moreover, this could lead to the opening of new avenues for Sukuk structuring as well as private placements by Islamic investment banks.

4- PRICING

Pricing of Asset Banking products would depend on the tenure, credit exposure, risk profile of the customer, etc. To ensure that Shari'a compliant products are more competitive, it is not against Shari'a principles if such products are priced at par with conventional banking products.

CONCLUSION

Over a number of years, it has been proven that Islamic banking has huge potential in terms of growth in the overall assets and net revenues. However, introducing Islamic banking in Emerging Markets will lead to greater economic inclusiveness and better standards of entrepreneurship through channelizing the available credit and liquidity in a Shari'a compliant manner. However, there are many myths surrounding Islamic banking products. These myths had resulted from misconception or limited knowledge about Islamic banking.

Over a number of years, it was proven that Islamic banking was capable of inventing solutions for various financial needs. Such solutions were, sometimes, as simple as Auto Murabaha and Service Ijarah. Also, sometimes, these solutions were as complex as Nasdaq Murabaha or Covered Card.

Despite the macroeconomic benefit of introducing Islamic banking in Emerging Markets, it should be ensured that the approach of introducing the product is rational, prompt and, most importantly, in the interest of the all concerned parties. Sticking to "Islamic" term might be a hurdle considering religious sensitivities of Emerging Markets. Hence it is suggested to brand such an industry as "Asset Banking" to give a loud and clear message that Shari'a compliant products cannot exist without dealing with real assets. We presume this is a first step to moving away from the fake economies.

Banking Wisely!

Introducing Islamic Banking in New Markets

Dr. Yousuf Azim Siddiqi



Dar a-Safwah

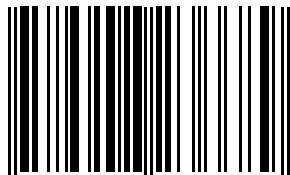
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